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Investment Update

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Points of interest:

- Vanguard sees a 70 percent likelihood that a balanced bond and stock portfolio will beat inflation over the next 10 years.
- It also says it is likely future balanced portfolio returns will be higher than those of the last decade.
- Return expectations for bonds are low due to their current high valuations.

Vanguard sees better years ahead for a balanced portfolio

The last 12 years have been rough for investors, subjecting them to two major bear markets and returns well below the previous 18-year bull market run.

Now they want to know what to expect over the next decade. Will the golden years of 14 percent-plus annual returns of the 1980s and 1990s reappear? Or will we face another miserable decade of lousy returns punctuated by frightening downdrafts?

Investors who are looking for happy days to return may have to adjust their expectations a little, but on the whole a balanced portfolio of stocks and bonds has at least a 70 percent chance of earning respectable profits, says the giant mutual fund company The Vanguard Group.

A balanced stock and bond portfolio has a pretty good chance of earning decent returns over the next decade.

Fair odds

"The likelihood that the average returns on a 50 percent equity/50 percent bond portfolio over the next ten years will exceed those of the past 10 years is approximately 70 percent," it said after conducting a study of prospective investment returns.

Vanguard expects returns on this portfolio to range from 4.5 percent to 6.5 percent a year. That is lower than the stock market's long-term average, but compares favorably to inflation, leading to real inflation-adjusted growth of 3.5 percent to 4.5 percent per year. The historical premium over inflation for such a portfolio has been about 5.1 percent, Vanguard said.

"Overall, we find that the expected risk/return trade-offs among stocks and bonds do not warrant abandoning the basic principles of portfolio construction—balance, diversification, and a strategic allocation based on long-term goals," Vanguard said.

Stocks look better

Vanguard did 10,000 simulations of possible stock and bond market returns over the next 10 years, based on market conditions as of Sept. 30 of last year.

"Our simulations suggest that the average return on a broad stock portfolio is likely to be higher than that for a broad bond portfolio given current equity valuations and as compensation for investors bearing greater equity-market risk," Vanguard said.

Although that might surprise investors who worry about ongoing economic headwinds, Vanguard notes that stock market valuations were at relative bargain levels in September, while bond market valuations were extremely high due to unprecedented low interest rates.

However, that does not mean that investors should

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Markets will look better, but don't expect 1980s returns

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give up on bonds altogether and invest solely in stocks. Such a move might bring higher returns, but also offers much greater downside risk, Vanguard said.

Despite current low interest rates, it expects investors will profit from "the beneficial role that bonds should be expected to play in a broadly diversified portfolio despite their present low yields and regardless of the future direction of interest rates."

It's not 1980

Investors should realize that investment conditions "today are less favorable for the future than they were in, say, 1980," Vanguard said.

At that time, "high bond yields and depressed P/E ratios provided tailwinds toward higher-than-average stock and bond returns during the decades of the 1980s and 1990s," it added.

However, a balanced portfolio going forward is preferable to chasing higher yields on riskier bonds or trying to restructure a portfolio to avoid potential stock market volatility, it said.

The outlook for stocks is pretty good.

Low-tech companies lead winners' list

High-tech U.S. stocks have been leading the market higher this year. Apple has been on a rapid ascent fueled by the sales of iPads and iPhones, while investors eagerly await the initial public offering of Facebook.

Back in the late 1990s Internet and tech stocks were all the rage. The sector had spectacular returns until the 2000-02 bear market.

So if you were looking back over the last 20 years for the best performing stocks, you would figure that high tech or Internet stocks would lead the list, right?

208 years old

Instead, an old technology that dates back to 1804 fueled the hottest stock of the last 20 years, reported the website SmartMoney.com.

The winner was Kansas City Southern, a railroad company that was up an astounding 19,030 percent over the past 20 years.

An investment of $25,000 in the stock back in 1992 would be worth $4.8 million today. Part of its success dated to ownership of the Janus Capital Group in the 1990s, a mutual fund company that specialized in growth stocks. Janus was spun off in 2000, just before it fell by 78 percent, while the railroad gained another 1,051 percent, partly due to cross-border trade with Mexico.

The second best stock was another unlikely company, Middleby, a maker of ovens and restaurant equipment. It gained 14,330 percent since 1992.

It wasn't Apple or General Electric or Microsoft that was the best stock over the last 20 years. They were bested by a Midwest railroad operator.

The winners list also had a number of tech stocks, including 10th-ranked Astronics of East Aurora, NY, which benefitted by selling its products to airlines updating their cabins. It was up 6,004 percent.

Not a cakewalk

Those unlikely winners show just how hard it is to pick individual winning stocks, and then to hold onto them through bad times. Qualcomm, for instance, was number 5 on the list, with a 20-year gain of 9,232 percent.

However, the maker of chips for mobile phones suffered a spectacular fall in the 2000-02 bear market, and at one point looked like it wouldn't make it. The stock fell from a high of $75 a share in 2000 to the low teens by 2002.

Many of the top ten firms were very small in 1992 and not on anyone's radar, SmartMoney says. Some were not followed by Wall Street analysts and would have been difficult to spot back then.

"Instead, an old technology that dates back to 1804 fueled the hottest stock of the last 20 years."

ONLY FOOLHARDY MUTUAL FUND INVESTORS AIM TO BEAT THE MARKET

The justification for investing in indexed and passively allocated mutual funds is powerful: funds that attempt to capture the market's overall returns—rather than beat the market– regularly outperform their competitors.

Yet that long-term evidence doesn't seem to dissuade the proponents of active mutual funds—those that attempt to beat the market through stock selection, industry allocation, or market timing.

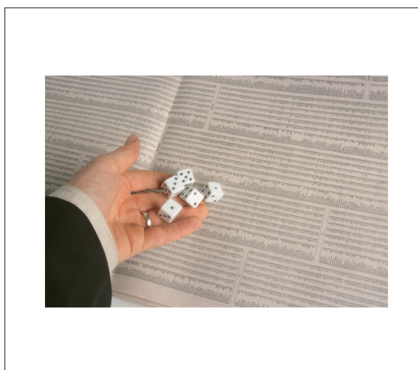
A satellite approach

One group of active investors has partially conceded the argument and agrees that investors should use indexed funds for their portfolio core, the part invested in large stocks.

At the same time, they argue that investors should use actively managed funds for the supposed "inefficient" areas of the market, such as the small and emerging market asset classes.

Proponents have dubbed this the "core and satellite" investment approach.

After doing an extensive study of this strategy The Vanguard Group, a large mutual fund manager, found that "indexing is a powerful strategy in all segments of the market." Only those very few investors who are skilled enough to pick the best actively managed mutual funds will be successful using them, it concluded.



Trying to pick winning mutual funds is a gamble for the majority of investors.

Vanguard looked at mutual fund managers operating emerging market and small cap stock funds from 1995 through 2009. Only one-third of the emerging market funds survived the entire period *and* beat their benchmark. Findings for active small stock funds were similar.

A skillful 5 percent

Then the company estimated the chances of an individual investor selecting a fund that survived the period and outperformed its market index.

Only 5 percent, or one out of 20 investors, would have been that skillful, it said. The rest of the investors would have failed to select the right active funds as their satellite choices, it found.

"We conclude that on a median basis, all investors would have benefited from having indexing as part of their portfolio, and that the 95 percent of investors with less than perfect skill would have benefited from having a majority of their portfolios in a market index," Vanguard said.

"Only one-third of the emerging market funds survived the entire period and *beat their benchmark."*

DOUGHNUTS, AMERICAN DREAMING, & MORE

Investors love to grab onto an attractive story, but hype about individual stocks frequently leads them astray.

Consider Krispy Kreme Doughnuts, the darling of the stock market in the early 2000s. The North Carolina based company was touted as the next Starbucks and was supposed to "cream" its rival, Dunkin' Donuts. It went public in April 2000 and traded as high as $108.50 a share in November of that year.

However, the Securities & Exchange Commission investigated and found out the company's books were cooked. Top executives were fined, and the stock today trades at around $8 a share.

No American dream

Four in 10 Americans say the American dream is out of their reach, found a survey by Yahoo! Finance.

A third of those responding to the survey said they have less savings than they did a year ago and that their financial situations are poor.

Almost two-thirds of those surveyed believed the U.S. economy is getting worse.

Baseball star defrauded

Even a two-time World Series catcher is not safe from investment fraud.

Former Boston Red Sox catcher Doug Mirabelli recently won an arbitration award of $1.2 million after he claimed a Bank of America Merrill Lynch adviser lost their initial investment of $880,219 in 2008.

It was the second arbitration award by a client made against Merrill adviser Phil Scott.

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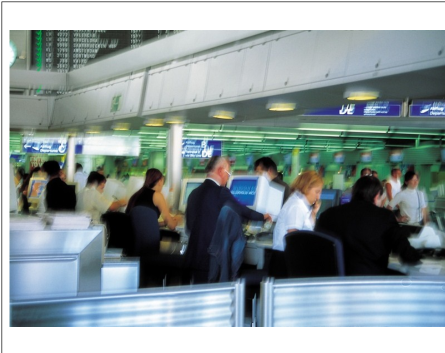
Is there a 'free lunch' waiting in inefficient stock markets?

Are there areas of the stock market where stock prices are not efficient and skillful investors can scope out bargains overlooked by other investors?

That argument is commonly used to justify active stock selection among small stocks and emerging markets stocks.

Proponents accept that prices on big U.S. and overseas developed market stocks are probably efficient, meaning that there is so much competition among investors that all relevant news is immediately priced into the market. Any individual investor's information or insight on a particular stock is probably already factored into its price.

If that is true, an investor is better off using an indexed mutual fund for large U.S., European, and Asian stocks.



Competitive trading probably means that all investment markets are efficiently priced.

Two top investment academics say that there is no evidence that smaller markets - such as those of small stocks or stocks of emerging markets like Brazil, Poland, and India - are inefficiently priced.

Eugene F. Fama of the University of Chicago and Kenneth R. French of Dartmouth College made their reputations studying returns of small stocks.

One argument for inefficient small stock prices claims they are often neglected. "If no one is paying attention to a group of small stocks, for example, how could their prices possibly be accurate?" French asks. He said the argument "may have had some merit 150 years ago," but seems out of date in an era where "hundreds of billions of dollars" are spent by investors each year looking for pricing errors."

When it comes to emerging markets, the argument is "that investors in some markets are ripe for the picking because they are just not as sharp as the rest of us," Fama says. But that argument is flawed: "People are bright and highly motivated in markets around the world," making those markets efficient too, he adds.